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SUBJECT: East African Community Customs Union: Just Teething Problems or Falling Apart?

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1. (SBU) Summary: The East African Community Customs Union, established at the start of 2005, is experiencing teething problems - and in the minority view, may be unraveling. A slew of problems, ranging from tariff rates for pharmaceuticals to rules of origin for vehicles assembled locally by General Motors, confronted EAC ministers at a recent meeting in Arusha, Tanzania. Kenyan government officials downplay the seriousness of these disputes, and see them as a natural result of closer trade ties within the EAC region, which combines Kenya, Tanzania, and Uganda. Kenyan observers, however, nonetheless see Tanzania as the potential wildcard, claiming the latter has a fear of Kenyan competition and a lingering ideological distaste for capitalism and free trade. It's probably too early to tell whether the EAC Customs Union succeeds in expanding trade and prosperity in the region, collapses, or just muddles along without actually achieving much in the way of tangible integration and growth. End summary.

The ABCs of the EAC Customs Union

2. (U) The original East African Community collapsed in 1974 due to differences between the countries' leaders and levels of economic and industrial development. Beginning in the mid-1990s, Kenya, Tanzania, and Uganda renewed the process of regional economic integration by forming a grouping called East Africa Cooperation, which they transformed into the East African Community (EAC) in 2001. In the future, the leaders of the three EAC states have ambitious plans for a monetary union, free movement of labor, and eventually some form of political union. But as a first step towards this kind of deeper political and economic integration in a grouping that comprises a combined GDP of \$27 billion and 90 million consumers, the EAC treaty provided for the formation of a customs union by 2004. Ready or not, the EAC Customs Union thus came into existence on January 1, 2005.

3. (U) As negotiated by the three members states, the EAC Customs Union is not by definition a pure customs union - at least not yet. The Customs Union indeed creates a common external tariff (CET) for all goods imported from outside the union. The CET consists of three bands - 0% for raw materials, 10% for intermediate goods, and 25% for finished products. But within the union, the accepted principle of asymmetry recognizes that Kenya's relatively larger and more competitive economy requires that both Uganda and Tanzania be permitted to continue to assess a "suspended duty" on a select group of "imports" from Kenya. For Uganda, this list comprises 443 products whose tariffs will be reduced from 10% to 0% over five years. Tanzania will apply a shifting set of tariff rates and reductions to a total of 880 products lines, but all rates will go to zero after five years.

Teething Problems - or Worse?

4. (SBU) Media reports in Kenya in late August and early September following the EAC's 10th Council of Ministers meeting in Arusha, Tanzania indicated that the well-intentioned Customs Union is at best experiencing teething problems. Some business contacts, frustrated by the slow pace of implementation of the union, go further and believe it could be unraveling. Contentious disputes between the member states in Arusha in August reportedly centered on the following:

-- Kenya and Pharmaceuticals: In April, EAC ministers

decided to make an exception and lower the CET on pharmaceutical products from the 10% intermediate rate to zero, largely in response to a chorus of protests from the healthcare community in the context of the region's HIV/AIDS pandemic and other health challenges. Kenya, which had always zero-rated pharmaceuticals, was seen as leading the charge to make this exception. (Note: The U.S. Mission to Kenya, home to the largest single PEPFAR program worldwide, specifically pressed the Kenyan government to zero-rate all drugs used to treat HIV/AIDS. End note). Tanzania, according to Kenyan media reports, fought back during the August Council of Ministers meeting, with the country's small pharmaceutical industry reportedly threatening to sue Kenya over the issue.

-- Tanzania and NTBs: The press also made hay of the alleged pique expressed in Arusha by Kenya's Minister of Industry and Trade, Mukhisa Kituyi, over a series of non-tariff barriers (NTBs) being imposed on Kenyan products to prevent them from crossing into Tanzania, including a \$50 fee imposed on Kenyan traders and businesspeople at border crossing points. This followed earlier and intense press coverage in Kenya of the expulsion from Tanzania of three Kenyan journalists perceived to have written politically-incorrect news reports.

-- Uganda and Infant Industries: A week after the ruckus over duties on pharmaceuticals, Kenya and Tanzania protested a Ugandan request to exempt from duty a list of products, tied to a list of specific companies, in order to allow these "infant industry" firms to survive and prosper. Kenyan Trade Minister Kituyi was quoted in the local press as saying, "National interests also have to be involved on how we negotiate, how much more concession should be given to Uganda."

GM: Not Reaping Rewards of the Customs Union

15. (SBU) The experience of General Motors East Africa, a Nairobi-based vehicle assembler owned by GM, illustrates the problems the Customs Union faces in achieving its ultimate objective of expanding intra-regional trade. Bill Lay, GM East Africa's Managing Director, believes the union will implode eventually - though perhaps his opinion should be taken with a grain of salt given his personal experience. He began laying the groundwork for taking advantage of the Customs Union early on, establishing contacts and dealers in Tanzania and lobbying early and often for favorable rules of origin for his assembled vehicles. After selling a small number of trucks and vans into Tanzania in the spring, hassles began at the border according to Lay, and by June, Tanzania's Finance and Foreign Ministers were loudly protesting against the Union's agreed-upon "substantial transformation" rule of origin. Under this provision, a product like GM's vehicles assembled from imported kits is considered to be locally produced if the conversion from inputs to finished product results in a change in classification of the final product's tariff heading.

16. (SBU) Lay says Kenya and Uganda went along with Tanzania and the substantial transformation provision was suspended until the end of the year, which means he has to fall back on a far less favorable methodology requiring a more expensive process of demonstrating at least 35% value-added local content. Lay says it's difficult for him to meet this rule because fewer and fewer local parts makers can produce the increasingly high-tech parts that go into his assembled vehicles. Caught in this catch-22 and now unable to sell vehicles into Tanzania after so much planning, Lay says despairingly that auto assembly and manufacturing has little future in East Africa. He is looking at an import-based strategy over the next few years and is already importing and selling South Korean-made Chevys in Kenya. Lay blames Tanzania's resistance to GM's locally-assembled vehicles on politically well-connected importers of used vehicles in Tanzania.

Kenyan Officials: All's Well in the Customs Union

17. (SBU) Senior Government of Kenya (GOK) officials deny the Customs Union is in any danger of falling apart. Trade Minister Kituyi told the press in early September that "teething problems and even beyond teething" are a normal result of closer trade relations between neighbors, just as EU member states battle over agricultural subsidies. In a September 6 meeting, Kituyi's Permanent Secretary, David Nalo, told Econoffs that the problems reported in the press were blown out of proportion. He ticked off the final results of the August Ministerial meeting with regard to each trouble spot:

-- Pharmaceutical Duties: While the Tanzanian private sector

remains vociferously opposed to the 0% duty, the Government of Tanzania told EAC ministers that it is fully committed to zero-rating, and will remain so. This issue, said Nalo, is resolved.

-- Tanzania's NTBs: Barrack Ndwega, Director of the EAC Directorate at the Ministry of East African and Regional Cooperation, told Econoff on September 20 that non-tariff barriers remain a problem, and that Kenya has "a long list of NTBs blocking our goods." But he said that the EAC Secretariat is establishing a mechanism, to be up and

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running hopefully by November, to identify and deal with NTBs as they arise. The \$50 fee on Kenyan businesspeople entering Tanzania has been dropped, he said.

-- Uganda's Infant Industries: Nalo said EAC ministers had agreed in principle with Uganda's argument to provide preferential treatment to certain key infant industries, given the country's relatively lower level of development. But the issue became contentious, he said, when Uganda submitted a list of duty-exempt products to be imported by a list of infant industry firms. Both lists, he said were inflated, to the consternation of Kenya and Tanzania. The list of 134 products was investigated and pared back to 51, and the list of 112 infant enterprises cut back to 34. In the end, ministers resolved to establish a mechanism at the EAC Secretariat to track infant enterprises in Uganda, which will only be allowed preferential treatment if they sell their finished goods locally in Uganda. Once they are ready to "export" products to other union members, they will have to pay normal tariffs on their imported inputs and/or pay a duty of some kind so as not to undermine competitors within the EAC area.

-- Cars and Rules of Origin: In contrast to GM's far bleaker assessment, Nalo said the issue of rules of origin has been resolved and that only GM's most stripped-down truck models are unable to meet the 35% local content criteria. Ndwega of the Ministry of East African and Regional Cooperation conceded that Kenyan products are often blocked by disputes over rules of origin, but claimed these issues are being ironed out.

Comment I: Time Will Tell

18. (SBU) We are rooting for its success, but only time will tell whether the EAC Customs Union succeeds in significantly boosting trade and prosperity in East Africa or falls apart thanks to political and/or economic differences between its members. A third path might be to simply muddle along, alive in name, but failing to expand prosperity significantly as members cave in to narrow, short-term interests and find ways to constantly stymie truly free trade - as appears to be the case thus far.

Comment II: Kenya vs. Tanzania?

19. (SBU) From the Kenyan perspective, the potential spoiler in the mix is clearly Tanzania, for two reasons. First, Kenyans believe that Tanzania is fearful of being swamped economically by a more competitive Kenya and more aggressive Kenyans. Second, they suspect that Tanzania, having abandoned socialism more recently, still has lingering ideological misgivings about the benefits of free trade and market-based economics, and that it therefore has less enthusiasm for the Customs Union generally. On this note, Trade Permanent Secretary Nalo reported that Kenya initiated a very frank closed-door session at the end of the recent ministerial meetings at which Tanzania's alleged xenophobic tendencies, as manifested in the expulsion of the three Kenyan reporters in July, were put on the table and discussed as an obstacle to progress in the Customs Union. Kenya, in turn, is perceived as arrogant and overbearing within the region, at least according to some observers, precisely because of these views.

110. (SBU) Finally, there may be a structural challenge, as well. Tanzania, it is noted, is a member of the EAC, but unlike Kenya and Uganda, is not a member of the Common Market for Eastern and Southern Africa (COMESA), a 21-member regional trade bloc that plans to form an even larger customs union by 2008. Tanzania withdrew from COMESA in 2000 and is instead a member of the Southern African Development Community (SADC), while Kenya and Uganda are not. We frankly aren't sure what this means for the future of the EAC Customs Union, but would warmly welcome perspectives on these issues from colleagues at Embassies Dar, Kampala, and elsewhere in the region.
Bellamy